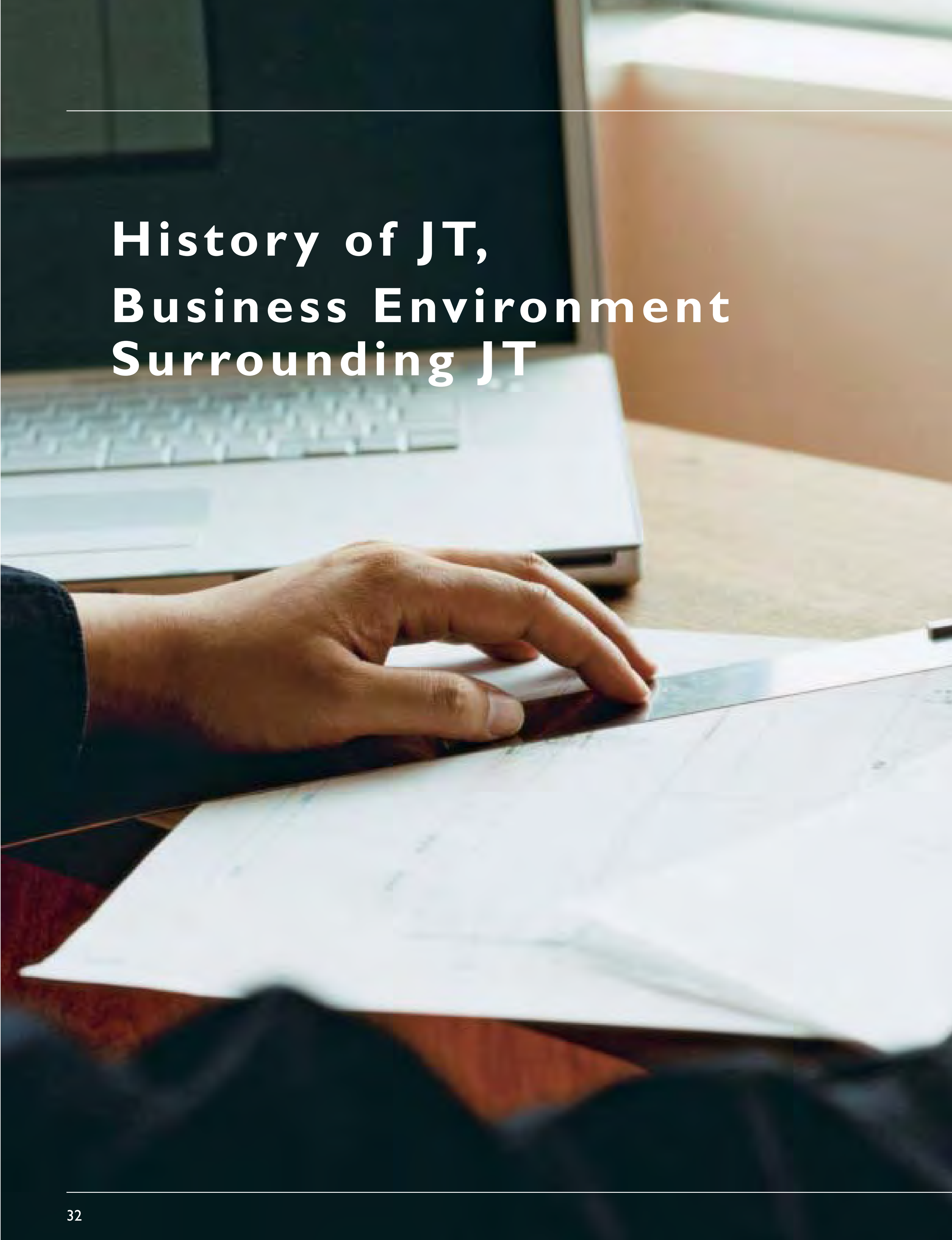
History of JT, Business Environment Surrounding JT




JT
Roots
AROMA
BLACK
ORIGINAL

History of JT

JT is a joint stock corporation, incorporated in April 1985 under the Commercial Code of Japan, pursuant to the Japan Tobacco Inc. Law, or the JT Law.

Our history dates back to 1898, when the government formed a bureau to operate a monopoly for the sale of domestic leaf tobacco. In the early 1900s, the government extended this monopoly to all tobacco products in Japan and to the domestic salt business. In 1949, the bureau became the Japan Tobacco and Salt Public Corporation, or JTS, which was charged with acting as the country's sole producer and supplier of tobacco and sole purchaser and supplier of salt products.

The growth in demand for cigarettes in Japan began to slow in the mid-1970s as a result of several factors, including demographic trends, health concerns, price increases, and a peaking of the rate of cigarette consumption per smoker. During this period, even though JTS had already commenced sales of imported foreign-made tobacco products in Japan, there was increasing pressure from abroad to open the Japanese tobacco market.

JTS also faced a number of constraints due to its status as a public corporation. For example, the Corporation's operating budget

Date	Details of change
April 1985	Japan Tobacco Inc. was established. (The Japanese tobacco market was opened to foreign tobacco manufacturers.)
	The Business Development Division was established to promote active development of new businesses.
	Subsequently until July 1990, in order to reinforce the promotion system for each business, this division was reformed and business departments were established dealing with medicine, food, etc.
March 1986	In the interests of modernization and improved tobacco production efficiency, the Fukuoka Factory and Tosu Factory were closed down and the new Kita Kyushu Factory was established.
	Subsequently until June 1996, nine more tobacco factories were closed down in further moves towards rationalization of the tobacco production system.
April 1987	Customs duties on imported cigarettes were reduced to zero.
October 1988	The communication name "JT" was introduced.
July 1991	The Head Office was relocated from Minato-ku to Shinagawa-ku to make way for the construction of the new Head Office building.
September 1993	The Central Pharmaceutical Research Institute was established to reinforce JT's internal pharmaceutical R&D capabilities.
October 1994	The initial public offering took place of JT shares held by the Japanese government. (394,276 shares, Offering Price: ¥1,438 thousand)
	JT shares were listed on the First Section of the Tokyo, Osaka and Nagoya Stock Exchanges.
November 1994	JT shares were listed on the Kyoto, Hiroshima, Fukuoka, Niigata and Sapporo Stock Exchanges.
May 1995	The Head Office was relocated from Shinagawa-ku to Minato-ku.
June 1996	The second public offering took place of JT shares held by the Japanese government. (272,390 shares, Offering Price: ¥815 thousand)
April 1997	In accordance with the abolition of the salt monopoly, JT ended its salt monopoly business.
	The Tobacco Mutual Aid Pension scheme was united with the Employees' Pension scheme.

and capital investment plans were subject to approval each fiscal year by the Japanese Diet, which made long-term management planning difficult. JTS was also required to purchase all domestically grown leaf tobacco, which was generally produced in excessive quantities, at prices significantly higher than those of foreign-grown leaf tobacco. Moreover, JTS was barred from entering other business areas. It became apparent that if the domestic tobacco market were to be opened, the Corporation would require greater management independence to compete with foreign tobacco companies. At the same time, in the context of an administrative reform initiative in Japan, there was increased public interest in the privatization of public corporations. Accordingly, a 1982 government report recommended that JTS be privatized, which led to the enactment of the JT Law in 1984, the establishment of our Company in April 1985, and our acquisition of the business and assets of JTS.

The main changes since the establishment of the Company are as follows:

Date	Details of change
April 1998	JT signed an agreement with Unimat Corporation to form a business alliance in the soft drinks business and acquired a majority stake in this company.
December 1998	JT acquired a majority stake in Torii Pharmaceutical Co., Ltd. through a takeover bid.
May 1999	JT acquired the non-U.S. tobacco business of RJR Nabisco Inc.
July 1999	JT acquired the foods division of Asahi Kasei Corporation, including eight subsidiaries such as Asahi Foods.
October 1999	Through the business alliance with Torii Pharmaceutical Co., Ltd., R&D in the medical pharmaceutical business was concentrated in JT while promotion functions were united within Torii Pharmaceutical.
March 2003	In order to establish a basis for future profit growth in the domestic tobacco business, the Sendai, Nagoya and Hashimoto Factories were closed down.
October 2003	JT obtained 45,800 of its own shares in order to expand its management options.
March 2004	In order to establish a basis for future profit growth in the domestic tobacco business, the Hiroshima, Fuchu, Matsuyama and Naha Factories were closed down.
June 2004	The third public offering took place of JT shares held by the Japanese government. (289,334 shares, Offering Price: ¥843 thousand), completing the sale of shares above the minimum threshold that the government is legally required to maintain.
November 2004 ~ March 2005	JT obtained 38,184 of its own shares in order to expand its management options.
March 2005	In order to establish a basis for future profit growth in the domestic tobacco business, the Ueda, Hakodate, Takasaki, Takamatsu, Tokushima, Usuki, Kagoshima and Miyakonojo Factories were closed down.
April 2005	JT ceased to produce, sell and use Marlboro brand cigarette exclusively in Japan upon the expiration of the licence term.
April 2006	A stock split with a ratio of five new shares per share was conducted with the aim of expanding the investor base. (Effective date: April 1)
April 2007	JT acquired whole stake in Gallaher Group Plc.

Business Environment Surrounding JT

Cigarette Vending Machines with Adult Identification Functions
(See P39 for more details)

Main Regulations Surrounding the World's Tobacco Business

WHO: Framework Convention on Tobacco Control

During the May 1999 World Health Assembly of the WHO, a resolution was adopted to commence work that lead to adoption of the Framework Convention on Tobacco Control (FCTC). Following six rounds of intergovernmental negotiation, the FCTC was adopted in May 2003 and entered into force on February 27, 2005, the 90th day after its ratification by 40 signatory nations. Moreover, as a result of the convention's entry into force, in February 2006 the first conference of the parties to the FCTC was held with the participation of 110 signatory nations including Japan, a further 49 non-signatory nations, and UN agencies. At this conference, discussions were held concerning such items as the procedural rules for subsequent conferences of the signatory nations, reports to be presented at the next conference, and the production of draft guidelines and draft protocols. As of May 31, 2007, 147 countries in total (including the EU) had signed the FCTC. Japan signed the FCTC on March 9, 2004 and accepted it on June 8, 2004. The FCTC contains a number of provisions, some of which are legally binding for the signatory nations while others allow for discretion by each signatory nation in respect to interpretation and implementation. Key provisions of the FCTC include:

— **Establishing price and tax measures (imposition of taxation policies, price policies, restrictions on duty-free sales, etc. as appropriate without prejudice to national sovereign taxation policies)**

— **Packaging and labeling measures (adoption of effective measures to ensure that tobacco product packaging and labeling do not promote tobacco products by using terminology that could create an erroneous impression that tobacco products carry low risk of harmful effects, and that health warnings on tobacco packaging cover not less than 30% of the principal display area)**

— **Advertising (a comprehensive ban on tobacco advertising, sales promotion and sponsorship or suitable restrictions if a country cannot implement a comprehensive ban because of its constitution or constitutional principles)**

— **Sales to minors (adoption and implementation of effective measures to ban sales of tobacco products to minors)**

— **Providing support for alternative activities (promotion of alternative activities for tobacco workers, growers and sellers as appropriate)**

The JT Group has long been committed to many of the FCTC's provisions, including prevention of underage smoking and curbing illicit trade. JT believes, however, that it is better for tobacco to be regulated by individual countries who can best determine the most appropriate legislative and regulatory framework in the light of their own conditions and taking into account their own unique legal systems, cultures and social circumstance. As needed, the JT Group intends to work with the government of each signatory nation on appropriate and reasonable measures in accordance with the situation of each county through which the FCTC's provisions can be implemented.

International Tobacco Product Marketing Standards

In September 2001, JT and several other tobacco companies reached an agreement on International Tobacco Product Marketing Standards. These standards set a baseline for responsible tobacco product marketing worldwide. The cornerstones of the standards are ensuring that brand marketing has no particular appeal to youth; restricting youth exposure to tobacco marketing; and ensuring that adult smokers are appropriately informed about the risks of smoking. Accordingly, marketing activities in Japan are subject to the standards.

The key features of the international standards include:

— **Uniform definitions of advertisement, promotional events, and sponsorship.**

— **Tough guidelines applicable to advertising tobacco products:**
- Print advertising is limited to publications with at least 75 percent adult readership.
- Billboard advertising must not exceed 35 square meters in size.
- Advertising on television, radio and the Internet are prohibited unless a 100% adult audience can be verified.
- Advertisements cannot run in cinemas unless there is a reasonable basis to believe that at least 75% of the audience is adult.
- Advertisements cannot feature celebrities, show individuals that appear younger than 25, or suggest that smoking enhances athletic, professional, personal or sexual success.

— **Display of health warnings on advertisements and other mediums:**
- Except for in a very small number of cases such as point-of-sale materials that are smaller than 250 sq. cm, health warnings must appear on virtually all advertising, promotional and merchandising materials.

— **Restrictions on sponsorship:**
- For events or activities that bear a tobacco product brand name, all participants who compete or otherwise actively participate must be adults.
- From December 1, 2006, attendance at an event or activity sponsored for the purpose of tobacco product brand promotion must be comprised of at least 75% adults, and these events can only generate incidental coverage in electronic media.

— **All promotional activities are limited to verified adult smokers.**

Prevention of Youth Smoking

The prevention of youth smoking is an issue to be addressed by all members of society. The JT Group has been taking various steps toward dealing with this problem in the countries in which it operates, based on its own standards, relevant local laws and regulations, and the International Marketing Standards (IMS).

For detailed information on JT's efforts to prevent smoking by youths, please refer to our website.
http://www.jti.co.jp/sstyle/think/underage/index.html
(for efforts in Japan)
http://www.jti.com/english/corp_responsibility/youth_smoking_prevent.aspx
(for efforts overseas)

Main Regulations Surrounding the Japanese Tobacco Business

The Japan Tobacco, Inc. Law

JT was established under the Japan Tobacco, Inc. Law (JT Law) for the purpose of developing businesses related to the manufacture, sale, and import of tobacco products. The JT Law provides that the Japanese government must continue to hold at least one-half of all of the shares that the government acquired by voluntary conveyance upon JT's establishment (the number of such shares following the share split carried out on April 1, 2006 is 5 million shares), and that even if JT issues new shares in the future, the government must continue to hold more than one-third of all of the issued shares. The JT Law also states that the flotation of new shares, options to subscribe for new shares, or in case of share-for-share exchange, issuance of new shares, issuance of options for new shares, or issuance of bonds with options or warrants to subscribe for new shares, requires the approval of the Minister of Finance.

The JT Law grants JT the freedom to enter other non-tobacco-related business areas in line with its overall objectives as a corporation, dependent upon ministerial permission, in addition to the manufacture, distribution, and import of tobacco products and tobacco-related businesses. JT must also obtain authorization from the Minister of Finance for certain matters, including the appointment or dismissal of directors, executive officers, and auditors, amendments to JT's Articles of Incorporation, appropriations of capital surplus (except disposal of losses), and any merger, corporate split, or dissolution of JT. Within three months after the close of each business year, JT must issue its balance sheets, statements of income or loss, and business report to the Minister of Finance.

The Tobacco Business Law

The Tobacco Business Law was enacted in August 1984 for the purpose of achieving sound growth for Japan's tobacco industry, securing stable government revenues, and contributing to the healthy expansion of the Japanese economy. The Tobacco Business Law governs the cultivation and purchase of leaf tobacco and the manufacture and distribution of tobacco products. JT is obliged to negotiate contracts with domestic leaf tobacco growers to determine the total area used for tobacco cultivation and tobacco leaf prices based on type and quality. JT is required to purchase the entire usable domestic tobacco crop. Contracts stipulate the area to be cultivated and the prices of leaf tobacco for the subsequent year, and in this regard JT respects the opinion of the Leaf Tobacco Deliberative Council.*

As the sole manufacturer of tobacco products in Japan as established by law, JT must obtain the approval of the Minister of Finance on the maximum wholesale price of each class of tobacco released to the market. Tobacco product importers and wholesalers must register with the Minister of Finance, and retailers of tobacco products are required to obtain approval from the Minister of Finance. In addition, list prices for JT's tobacco products and imported tobacco products must be approved by the Minister of Finance, although in general, manufacturers' list prices are approved unless the Minister of Finance deems them unfair to consumers. Tobacco retailers are only permitted to sell tobacco products at list prices that have been approved by the Minister of Finance.

*The Leaf Tobacco Deliberative Council is a council for conferring on important matters concerning the cultivation and purchase of domestically grown leaf tobacco in response to inquiries by JT representatives. The council consists of no more than 11 members, appointed by JT with the approval of the Minister of Finance from among representatives of domestic leaf tobacco growers and academic appointees.

Cautionary Statements

In Japan, based on Article 39 of the Tobacco Business Law, the packaging of tobacco products must, as stipulated in Article 36 of the Tobacco Business Law Enforcement Regulations, include "statements to promote caution regarding the relationship between the consumption of tobacco products and health (cautionary statements)."

The cautionary statements, laid out specifically in the Tobacco Business Law Enforcement Regulations, specify eight types of warning labels: four regarding direct effects of smoking (lung cancer, heart attack, stroke, and emphysema), one about smoking by pregnant women, one about passive smoking, one about smoking dependence, and one about underage smoking. Each tobacco product package must contain, on its main surfaces, at least one of the first four types (direct) and at least one of the other four types. The regulations specify that the various types must be visible equally throughout the year on every category of product and packaging, and that these warnings must take up 30% or more of the main surfaces of the package.

In addition, the regulations specify that if the words "mild," "light," or similar words are used, they must be accompanied by specific notation so as to avoid misleading consumers about the relationship between the consumption of tobacco and health. All of the required indications have been appropriately printed on all JT tobacco products for domestic shipment, as prescribed by the above regulations.

Also, JT will continue using the words "mild," "light," and similar words in the domestic market, in accordance with obligations stipulated by the ordinance.

Guideline on Tobacco Advertising

In Japan, a guideline has been published concerning advertising of tobacco products by the Minister of Finance, based on Article 40 of the Tobacco Business Law. The TIOJ* has drawn up self-regulatory standards in line with this guideline and all TIOJ member companies including JT are abiding by these standards.

The guideline stipulates that outdoor advertising of tobacco products (posters, billboards, etc.) must not be displayed except where tobacco products are sold, or in designated smoking areas. It also stipulates that consideration must be given to methods of advertising in daily newspapers (with the exception of tabloids) and specifies items concerning the display and content of cautionary statements allowed for all tobacco advertising.

In consideration of these guidelines, the TIOJ has established voluntary codes and its member companies including JT are continuing to implement new measures as required, such as banning outdoor billboard advertising or brand-specific advertising in public transportation, limiting the volume of advertising in newspapers, and specifying which sections of newspapers may contain such advertising.

*Tobacco Institute of Japan: The TIOJ is a public service corporation established for the purpose of contributing to the promotion of a fair and objective social understanding of tobacco through the collection and propagation of information regarding tobacco, enhancement of the sound development of the tobacco industry in Japan, and thereby the contribution to the sound progress of the national economy by responding appropriately to the social environment surrounding tobacco and carrying out various activities.

The TIOJ was established as a voluntary organization in 1987, and reorganized as an incorporated body in 1990, as an offshoot of the Association of Tobacco Manufacturers, which was established in 1985.

Prevention of Youth Smoking

Cigarette vending machines with adult identification functions

In November 2001, the Tobacco Institute of Japan (TIOJ), the Japan Tobacconist Federation, and the Japan Vending Machine Manufacturers Association reached an agreement to cooperate in the development and implementation of cigarette vending machines with adult identification functions and have been working together toward equipping all vending machines throughout Japan with such functions by 2008. Vending machines with these functions are designed to prevent minors from purchasing cigarettes from vending machines and will dispense cigarettes only after scanning and verifying special IC cards that indicate whether the purchaser is an adult or not.

A one-year trial use of these new machines was conducted from April 2002 to March 2003 in Yokaichiba, Chiba Prefecture, with the full support of local authorities. Basic technical and operational knowledge was attained and market receptivity was ascertained. We are now at the stage of making necessary preparations building on the results of these tests and those of a further trial in Tanegashima, Kagoshima Prefecture toward the construction of a system for nationwide introduction of these machines in 2008. JT fully respects the intentions of these cooperative efforts and intends to actively participate in the smooth development and implementation of cigarette vending machines with adult identification functions.

Tobacco-Related Litigations

Smoking Health-Related Litigation

JT and its subsidiaries are defendants in lawsuits filed by plaintiffs seeking damages for harm allegedly caused by smoking or exposure to tobacco smoke. Up to the present, JT and its subsidiaries have never lost a case or paid any money to settle a case out of court.

At present, JT is involved domestically in the following lawsuit related to smoking and health.

Three smokers who contend that they developed diseases allegedly as a result of smoking filed a lawsuit on January 19, 2005 with the Yokohama District Court against JT, the Government of Japan, et al., asking for a total of 30 million yen in compensation for damages and a strengthening of the wording of warnings placed on tobacco products, etc. The first hearing in this case took place on April 20, 2005, and the case is still pending in the district court.

Lawsuits related to smoking and health in which JT subsidiaries are defendants outside Japan include damages claims filed by individuals, medical expense recovery lawsuits filed by governments and insurers, and class actions for damages and injunctive relief. As of the end of May 2007, a total of 9 such lawsuits were pending in which JT or its subsidiaries are named as a defendant or for which RJ Reynolds Tobacco Company (RJR) has sought indemnification following JT's acquisition of RJR Nabisco Inc's overseas (non-US) tobacco operations.

Among these smoking and health related lawsuits, there are three actions in Canada: one is an action brought in January 2001 by the province of British Columbia against major cigarette companies, including RJR and the Canadian subsidiary of JT, JTI-Macdonald Corp ("JTI-Macdonald"), seeking the recovery of health care costs allegedly incurred as a result of the defendants' asserted misconduct; the other two lawsuits are class actions in Quebec against the major Canadian cigarette companies, including JTI-Macdonald, authorized in February 2005 and filed in September 2005. The British Columbia action is brought under a provincial statute entitled the "Tobacco Damages and Health Care Recovery Act", which was enacted for this action only. Several defendants challenged the statute's constitutionality. This challenge was finally rejected by the Supreme Court of Canada in September 2005. For the time being, both the Quebec class actions and the British Columbia action remain in pre-trial proceedings with no decision yet made as to JTI-Macdonald's or RJR's liability.

JT considers that there remains a possibility that other such smoking and health related lawsuits could be brought in the future.

JT is unable to make any predictions of the outcome of the pending or future lawsuits. However, if one or more actions result in a decision unfavorable to JT or its subsidiaries, the performance of JT and its subsidiaries could be materially affected by, for example, payment of monetary compensation. Moreover, regardless of the results of each lawsuit, critical media coverage of such lawsuits may decrease social tolerance toward smoking, increase interest concerning the relationship between smoking and health, strengthen public regulations concerning smoking, and prompt the filing of numerous similar lawsuits against JT and its subsidiaries forcing them to bear the expense of defending such lawsuits. In consequence, these factors could materially affect the business performance of JT and its subsidiaries.

Other Tobacco-Related Litigation

In addition to smoking and health cases, various kinds of smuggling and counterfeiting of tobacco products have created major problems for the entire tobacco industry. JT and its subsidiaries are defendants in lawsuits brought by the European Community and legal claims asserted by the federal and seven provincial governments in Canada seeking compensation for damages allegedly resulting from alleged cigarette smuggling. Also, JTI-Macdonald received a tax assessment from the Quebec Ministry of Revenue requiring immediate payment of the alleged loss of tobacco taxes. JTI-Macdonald has challenged the tax assessment in court. Further, there are lawsuits in which Russian subsidiaries of JT are contesting various tax assessments issued by the Russian tax authorities.

In November 2000, the European Community (the “EC”) commenced a civil action in the United States against various members of the JT, RJ Reynolds and Philip Morris groups claiming that they had conspired to smuggle tobacco products, thereby reducing tax revenues and harming other economic interests (“EC I”). A federal district court dismissed this case in July 2001. In August 2001, the EC and ten of its Member States commenced a second civil action in the same court against various members of the RJR and Philip Morris groups (“EC II”). The EC II was virtually identical to the earlier EC I, except that neither JT nor any of its subsidiaries was included as a defendant and the ten Member States were included as plaintiffs. In January 2002, the EC and the ten Member States commenced a third civil action identical in all material respects to EC II in the same court against, inter alia, JT and several of its subsidiaries (“EC III”). The plaintiffs did not (and still have not) served the JT-related entities. In February 2002, the district court entirely dismissed the EC II and EC III actions, and in March 2002, the plaintiffs appealed the dismissal of both EC II and EC III to a federal court of appeals. In October 2002, the EC and the ten Member States commenced a fourth similar civil action with added allegations of money laundering in the same court against RJR group (“EC IV”). Neither JT nor any of its subsidiaries was named as a defendant in EC IV. In January 2004, the federal court of appeals affirmed the district court’s dismissal of EC II, but vacated the district court’s dismissal of EC III because the JT-related entities had not been served with process. In April 2004, the EC II plaintiffs filed a petition for writ of certiorari to the United States Supreme Court. In May 2005, the Supreme Court summarily granted certiorari, vacated the judgment of the lower court, and remanded the action to the federal court of appeals. In September 2005, the court of appeals reaffirmed the district court’s dismissal in EC II. In November 2005, the EC II plaintiffs again filed a petition for writ of certiorari to the United States Supreme Court, which was denied on January 9, 2006.

In August 2003, the Canadian federal government filed a civil action in Ontario, Canada against RJR and its subsidiaries as well as JT and its subsidiaries, including JTI-Macdonald, which was acquired by JT when it took over the former non-U.S. tobacco operations of RJR Nabisco Inc in 1999. The suit mainly claims damages allegedly suffered by the Canadian government in connection with the alleged illicit importation of tobacco products into Canada.

In August 2004, JTI-Macdonald received a Notice of Assessment from the Quebec Ministry of Revenue requiring immediate payment of approximately 1.36 billion Canadian dollars (approximately 114.6 billion yen at the then-exchange rate) on claims that it had allegedly contributed to tobacco smuggling from 1990 to 1998. This amount consisted of allegedly lost tobacco taxes, with penalties and interest.

If the assessed amount were not paid, JTI-Macdonald faced the risk that it would not be able to continue its usual business operations in the face of collection action by the Quebec Ministry of Revenue. Therefore, in order to continue its operations, JTI-Macdonald filed a successful application under the Companies’ Creditors Arrangement Act (“CCAA”)* with the Ontario Superior

Court of Justice. JTI-Macdonald has since been continuing its business as usual under CCAA protection at least through May 30, 2008.

Filing for CCAA protection is not an admission that JTI-Macdonald contributed to smuggling as claimed by the Quebec Ministry of Revenue. JTI-Macdonald intends to challenge the tax notice submitted by the Quebec Ministry of Revenue through all appropriate means. Furthermore, in the event that JTI-Macdonald bears any damages or costs associated with this case, JT's view is that it will be entitled to seek indemnification from RJR Nabisco Inc or its successors, based on the contract entered among JT, RJR Nabisco Inc and RJR at the time of JT's acquisition of JTI-Macdonald in 1999.

At the invitation of the court presiding over the CCAA proceedings, six other provinces have filed claims similar to Quebec's, seeking taxes, interest, and penalties. No procedure is yet established for adjudicating these claims.

*Companies' Creditors Arrangement Act ("CCAA"): Companies doing business in Canada are eligible to seek protection under the CCAA if they encounter a financial situation that creates noticeable difficulties in their business operations. The CCAA's intent is to enable these companies to continue their operations while restructuring.

Many Canadian companies have undergone restructuring processes under the CCAA. Unlike bankruptcy proceedings, CCAA proceedings are not undertaken for liquidation. The fundamental characteristics of the CCAA are as follows:

- The company continues to manage and control its business and property;
- The CCAA is a very flexible law that can be tailored to fit the circumstances of each case;
- The company may seek to restructure its businesses or deal with contingent and other claims under court protection with the assistance of a court-appointed monitor;
- All lawsuits against the companies and other procedures are stayed, and companies are able to continue their businesses and carry out their restructuring;
- After the claims against the company are determined, the company may put a Plan of Arrangement before its creditors or some of them;
- If creditors have agreed to the aforementioned plan and the court approves it, it will be binding on the company and all affected creditors.

In May 2007, after a preliminary hearing on various charges arising from the alleged smuggling of tobacco products into Canada in the 1990s, a court in Ontario ordered JTI-Macdonald and one former employee to stand trial. This ruling determined neither the guilt nor the innocence of the defendants, which is to be determined at trial.

In July 2004, a Russian subsidiary of JT, JTI Marketing & Sales ("M&S Corp."), which oversees distribution-related businesses in the Russian market, received an assessment from the Moscow tax authorities in which it was ordered to pay approximately 2.4 billion rubles (approximately 8.8 billion yen at the then-exchange rate) as VAT, etc. for the period of January 2000 to December 2000. The taxed amount includes unpaid taxes (VAT, etc.), interest and additional taxes. M&S Corp. believes that the assessment from the Moscow tax authorities is based upon a misconception of general business practices and sued to invalidate the assessment. Although lower courts dismissed the claims of M&S Corp., the Russian Federation Higher Arbitration Court reversed the lower courts' judgments and remanded the case to the court of first instance in April 2006, where the action is pending.

In February 2005, another Russian subsidiary of JT, OOO Petro ("Petro") received an assessment from the St. Petersburg tax authorities that ordered payment of approximately 420 million rubles (approximately 1.6 billion yen at the then-exchange rate) as corporate tax, etc. and interest thereon from 2001. In February 2005, Petro challenged the assessment and, in September 2005, the court of first instance rendered judgment in favor of Petro. On appeal by the tax authorities, the court of appeals upheld the judgment of first instance in January 2006. Further, in April 2006, the cassation court also upheld the lower courts' judgments. The tax authorities filed a petition for writ of certiorari to the Russian Federation Higher Arbitration Court, which was denied in August 2006.

JT and its subsidiaries believe that they have valid defenses and claims in these pending cases. However, it is possible that the results of operations, cash flows of JT or the financial condition of JT could be materially affected by, among others, the ultimate outcome of certain pending litigation matters. Also, there remains a possibility that other such lawsuits could be filed in the future.

Major Risks of Businesses

The major risks to which JT and its subsidiaries' businesses are exposed and the factors which may materially affect investors' judgments are described as the following. This section contains forward-looking statements based on judgments made as of the end of this annual period. Future potential risks include, but are not limited to the risks stated hereunder.

Risks Relating to JT and its Subsidiaries' Businesses, Earnings Structure and Management Policies

- There is a risk that any negative impact on the domestic tobacco business (a major contributor to JT and its subsidiaries' sales and operating income) might negatively affect their overall business performance.
- JT and its subsidiaries plan to invest in the pharmaceutical and food businesses based on the view that these businesses will contribute to their business performance in the future, but there is a

risk that the investment might not generate the expected returns.

- JT and its subsidiaries might acquire other companies, invest in other companies, form alliances or build cooperative business frameworks with other companies based on the view that it will contribute to JT and its subsidiaries' future business performance, but there is a risk that their future business performance might be negatively affected if the results fall short of their expectations.
- There is a risk that overseas operations might face exchange rate fluctuations, change in laws and regulations, political unrest, uncertainties in economic trends, local industrial relations, revision of tax system, tariffs, etc., and differences in business practices.
- There is a risk that JT's consolidated financial statements might be affected by fluctuations in the exchange rate of the foreign currency used by its overseas subsidiaries for the closing of accounts relative to Japanese yen. There is also a risk that if overseas subsidiaries, whose shares were acquired in foreign currency by JT, are liquidated, sold, heavily diminished in value, etc., the gain/loss on investment in the subsidiaries recorded in JT's consolidated financial statements might be affected by fluctuations in the exchange rate between Japanese yen and the foreign currency used for acquiring the shares.
- While JT uses foreign currency hedges transactions to partially manage its transactional exposure of fluctuations in the value of foreign currencies, it remains exposed to effects of foreign exchange transactions.

Risks Relating to JT and its Subsidiaries' Domestic and International Tobacco Business

- JT predicts that aggregate cigarette demand will continue to decline in the domestic tobacco market as a whole. In the overseas tobacco market also, the demand might decrease depending on the economic environment and local situations, although there are some variations among regions. Therefore, there is a risk that a decline in tobacco demand might have negative impact on JT and its subsidiaries' business performance.
- JT and its subsidiaries' market shares in the domestic and the overseas tobacco markets fluctuate in the short run due to temporary factors, such as the launch of new products by JT and other tobacco manufacturers, and special sales promotion activities. There is a risk that JT and its subsidiaries' market shares in the tobacco market might decrease due to such factors as, competition, pricing strategy, changes in consumer preferences, brand recognition, and economic conditions in each market. There is also a risk that the measures adopted to counter the decrease in the market share, which might lead to increase in costs, might cause a decrease in profit.
- There is a risk that fluctuation in price of foreign leaf tobacco might have a direct impact on JT and its subsidiaries' operating income.
- There is a risk of a higher tax imposed on tobacco in the domestic and the overseas market.
- There is a risk that tobacco demand might decrease due to the strengthening of tobacco regulations. There is also a risk that costs to adapt to new regulations might increase.
- If the use of terms, such as "mild" and "light" in product names is banned, depending on the nature of legislations passed in each country, there is a risk that substantial costs and time might be incurred (spent) in developing a new brand that matches or is comparable to "Mild Seven" brand and the new brand may not achieve similar value and appeal.
- JT and its subsidiaries are being sued in Japan and overseas for allegedly causing smoking-related health problems. There is a risk that JT and its subsidiaries might be held liable for such health problems in these lawsuits. There is also a risk that, regardless of the outcome of the litigation, negative publicity from the litigation and other factors might make smoking less acceptable to the public, enhance public restrictions on smoking, induce many similar lawsuits against JT and its subsidiaries, forcing them to deal with and bear the costs of such lawsuits, and so on.
- Other than those relating to smoking and health issues, JT and its subsidiaries are defendants in claims brought by the European Community and several Canadian governmental entities claiming that JT and its subsidiaries allegedly contributed to tobacco smuggling and seeking compensation for damages. Also, JT and its subsidiaries have challenged unreasonable notices of assessment that JT's subsidiaries received both from the Quebec Ministry of Revenue and from Russian tax authorities. There is a risk that these claims might have a negative impact on JT and its subsidiaries' business performance or on the manufacture, sale, import/export, etc. of tobacco products if the rulings turn out to be unfavorable to them.

Risks Relating to Non-Tobacco Businesses

[**Risks relating to Pharmaceutical Business**]

- There is a risk that JT and its subsidiaries cannot research, develop and launch commercially valuable pharmaceutical products (JT has never released any proprietary pharmaceutical products).
- There is a risk that even if JT and its subsidiaries can research and develop or launch commercially valuable pharmaceutical products, the R&D costs might exceed the sales generated from them.
- There is a risk that even if JT and its subsidiaries' pharmaceutical products are commercially successful, its success might be checked by domestic and overseas competitors' products, government-mandated price decreases, etc.
- There is a risk that in the event of any problems in the quality of JT and its subsidiaries' pharmaceutical products or in the information provided on the products, claims, including product liability claim, might be brought against JT and its subsidiaries or a suspension of sales.
- There is a risk that JT's business performance might be affected by litigations concerning patents and other intellectual property rights.
- There is a risk that regulations might be applied broadly, from the R&D stage all the way up to the post-launch stage of a new drug.

[**Risks relating to Food Business**]

- There is a risk that the food products developed by JT and its subsidiaries might not meet consumer preferences, which could lead to a short product life.
- There is a risk that JT and its subsidiaries' profit/loss might fluctuate due to the volatility of the price of materials for food products (including those due to exchange rate fluctuations).
- There is a risk that the sales of JT food products are subject to the weather.
- There is a risk that the regulation of the procurement, manufacture, and sale of food products in Japan and overseas might be strengthened (including risks that various costs to comply with regulations might increase).
- There is a risk that JT and its subsidiaries might not be able to compete with larger companies with larger distribution channels and networks, stronger development capabilities and longer operating histories than JT and its subsidiaries.
- There is a risk that in the event of any problems in the quality of JT and its subsidiaries' food products, claims, including product liability claims, might be brought against JT and its subsidiaries and the reputation of the products and JT and its subsidiaries might be harmed.

Other Factors which Might Materially Affect Investment Decision

- The Japan Tobacco Inc. Law (hereinafter "JT Law") provides the government's obligation to hold a certain proportion of JT shares. Under JT Law, the government is required to hold at least one-half of all JT shares which the government acquired upon JT's establishment, as adjusted for any subsequent stock split or consolidation of shares, and the government must continue to hold more than one-third of JT shares. The government holds 50.02% of all outstanding JT shares as of the end of this fiscal year.
- The Minister of Finance has the authority to supervise JT under the JT Law and Tobacco Business Law.
- Under the JT Law, the scope of JT's businesses includes "manufacture, distribution, and import of tobacco products and ancillary businesses, as well as businesses required for attaining the objective of JT", while "businesses required for attaining the objective of JT" is subject to the Minister of Finance's approval. Accordingly, the Minister of Finance's approval is required in order for JT to engage in new businesses outside the scope of currently-approved businesses.
- The Tobacco Business Law requires us to enter annually into purchase contracts as to the aggregate cultivation area for specific varieties of leaf tobacco and prices for leaf tobacco by variety and grade. JT must purchase all leaf tobacco produced pursuant to such contracts that is suitable for the manufacture of tobacco products. JT is required to respect the opinion of the Leaf Tobacco Deliberative Council (Hatabako shingi kai), which consists of members appointed by JT with the approval of the Ministry of Finance from representatives of domestic leaf tobacco growers and academic appointees, in regards to the aggregate cultivation area and the prices for leaf tobacco.